

Remarks of Steven T. Miller
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Internal Revenue Service
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Thank you for your kind invitation to come speak with you this morning. I am a year into my new job, and while I am familiar with exempt organizations and have a good feel for tax exempt bonds and employee plans, I must admit I am somewhat less familiar with state and local governments.

At one point I wrote the regulations on Section 3121(b)(7)(F) – which was the extension of Social Security to state and local employees outside state retirement programs – but that was long ago and far away.

Let me start by saying that I believe I am among friends. I have worked with some of you on our advisory committee: Don Waugh of North Carolina, Daryl Dunagan of Kentucky, Dave Barrow of California, and Nick Merrill of Illinois, who I think speaks tomorrow. I am extremely impressed with the thoughtfulness and professionalism of those I have met to date. So I know a little about your organization and how important a partner you are with the Service.

We share the same objectives of helping state and local governments meet their responsibilities under the Social Security Act, and as importantly, trying to assure the income security of governmental retirees.

You have been at this work for a long time, since 1952, providing valuable assistance and advice to your individual states and political subdivisions. When it comes to Social Security taxes, we rely on you to get the right people to do the right thing at the right time. No small feat. For our part, we carry out our assignment – the collection of employment taxes and withheld wages from governmental entities – through our relatively new Federal, State and Local Government function.

The IRS began its involvement with Social Security in 1986, but we took a big step in January 2000. Former Commissioner Charles Rossotti believed that the Service was not giving state and local governments the prominence and attention they deserved.

We remedied this situation by creating a new office, specifically charged with meeting the needs of governmental entities in their role as payers of employment taxes. The new unit was Federal, State and Local Governments, FSLG for short.

It was placed within TE/GE, the Tax Exempt and Government Entities Division, which is the Division I now lead.

Although the TE/GE Division is the smallest of the Service's four operating divisions, we touch the lives of nearly everyone in the country. Our focus is not so much on collecting tax – although we do that – as it is on administering those portions of the Tax Code that exempt certain entities and activities from taxation. Thus, we are concerned with pension plans, 401(k)s and related tax-qualified retirement savings plans. We are also concerned with so-called 501(c)(3)s – charities, hospitals, universities, and other entities upon which Congress has bestowed the privilege of tax exemption. That also includes entities like unions, country clubs, state pre-paid tuition plans, and political action committees. We are concerned with tax-exempt bonds, and with Indian tribal governments that are tax-exempt but still pay employment taxes. And of course we are concerned with federal, state and local governmental entities in their capacity as employers.

We in TE/GE are responsible for approximately 3 million entities. These entities control nearly \$8 trillion in assets, and pay over \$200 billion in employment tax and income tax withholding.

The annual tax expenditure for these tax-exempt entities is approximately \$283 billion per year. Our job at TE/GE is to insure that those who are getting this enormous benefit of tax exemption are the kinds of entities, engaged in the kinds of activities that Congress intended.

Now you all are a little different. Our federal system means that the states are exempt from income tax. Our concern with your community has to do with excise and employment taxes. And you are an important part of the economy: governmental entities employ 1 of every 5 persons employed in the country.

Most of you have had some kind of contact with FSLG. The main thing I would like to talk to you about today is how we are re-balancing our efforts at the IRS, and in FSLG, and why. As I will explain, by re-balancing I mean placing a greater emphasis on enforcement. This shift in emphasis may well change the nature of some of the contacts we have with the states and political subdivisions you work with.

Let me put this in perspective. FSLG began its existence in January 2000. We first focused on outreach and education. Between 2000 and 2003, we conducted some 1,925 events with 99,428 attendees. That was quite an effort. We spent a lot of time just counting and identifying all the state and local units of government. There were more than we thought. We started out with an estimate of around 46,000, but now we count some 87,000 state and local entities.

We had two major goals early on. First, to let everyone know of our existence, and second, to do all we could to make sure that these entities, and federal

agencies, knew what their employment tax obligations were and how they could satisfy them.

We are beyond that initial stage now, and FSLG's focus is changing. After years in which our energies have been directed to customer outreach and education, with minimal effort on enforcement, we are re-balancing by elevating enforcement to the top of our agenda.

This shift toward enforcement is completely in line with the direction the Service has taken under Mark Everson, the current Commissioner of Internal Revenue. He has defined our operating philosophy in a simple "working equation": Service + Enforcement = Compliance. Not service or enforcement, but service and enforcement. Both are essential for good tax administration.

During the late 1990s, IRS enforcement practices came under pretty tough scrutiny in Congressional hearings. There was significant debate about how much enforcement the IRS should carry out. There was a view among some that enforcement should be de-emphasized.

But in recent years, as surveys of taxpayers reflect, a consensus has developed that strong enforcement is an essential function of the IRS and a necessary component of a successful tax system. This is true across the Service, and it is certainly true of TE/GE.

Clearly, it's Congress' view at this point. In just the past two months, we have had four hearings before the House Ways and Means Committee and the Senate Finance Committee on TE/GE enforcement issues alone. So far, none of these hearings has focused exclusively on governmental entities, though an earlier hearing has focused on tax shelter where governments have played a questionable role.

Because of this, I want to spend a moment on tax shelters. You may have read about the Service's ongoing efforts to attack tax shelters. We have been diligent about this and have had a great deal of success. For example, our Son of Boss initiative has recouped some \$3.7 billion for the government.

I'm raising the issue of tax shelters with you because state and local governmental entities are being asked to participate in certain kinds of shelters. They are being asked because the party seeking to defer or shift taxable gains needs a nontaxable entity to receive the income, in order to make the shelter work. An entity that is used this way, or that permits itself to be used this way, is called an "accommodation party." And state and local governmental entities have been recruited by promoters to play the role of the accommodation party in a number of abusive shelters.

In fact, government entities have played a role in at least two listed transactions – those transactions the Treasury Department has found specifically to be abusive.

More importantly for you in this room, we are beginning to see abusive transactions involving flexible health benefits being promoted to governmental entities. These transactions, and the resolution of them, may impact employment tax calculations and collections. This is an area where I would ask for your help.

If an unusual or too-good-to-be-true proposal comes to your attention, please be prudent, and be safe. Contact Sunita Lough, the Director of FSLG, or the FSLG specialist you work with, to discuss the proposal.

Enough on tax shelters – their rise is one reason we are stepping up enforcement. A second reason is the serious tax gap we have in this country.

The tax gap is the difference between what taxpayers are supposed to pay and what they actually pay. By our best estimates, we lose almost \$300 billion each year due to non-filing, underreporting, and underpayment. Within my area, Tax Exempt and Government Entities, employment taxes make up the biggest component of our portion of the tax gap.

So we have moved Service-wide to more enforcement. Should that apply with respect to governments? My answer is yes. As a matter of equity, if we push enforcement in the private sector, fairness demands we push it in the public sector as well. And I know you'll agree with me that if we step up our activity with state and local government, fairness demands we do the same across federal agencies as well.

And so it is my determination, and the determination of FSLG, to put some muscle into enforcement in this area.

In this effort to re-balance our emphasis, we have the full support of the Commissioner, and he has backed up his support with resources. Although the IRS budget increased only one-half of one percent in FY 2005, the TE/GE budget increased 9 percent.

Moreover, the Commissioner increased the FSLG enforcement budget to enable us to hire 26 new revenue agents. This is a 33% increase, a remarkable increase at a time when many budgets within the federal government are flat or declining. The take-home message is that IRS and FSLG enforcement activity is increasing in your area.

But what will this re-balancing mean for the states and their political subdivisions? As part of this, let me speak to you about the enforcement work and initiatives we have underway in FSLG.

First, let's talk about our move to compliance contacts. Second, I will discuss where we are focusing those contacts with the extra resources the Commissioner has provided.

Let me note that as we increase the number of compliance contacts, we will reduce the number of outreach events. In FY 2003, we had 779 outreach events that reached 41,145 individuals. This year, FY 2005, we will have 270 events that will reach 14,200 individuals. We are certainly not abandoning our efforts at customer education and outreach, but the ratio has changed from almost 100% education and outreach and very little enforcement, to 80% enforcement and 20% education and outreach.

Both compliance checks and examinations have increased, and they will continue to increase. In a compliance check we look at a return a taxpayer has filed and then ask questions with respect to it, without examining the taxpayer's books and records. We can convert a compliance check into an examination – where we do look at the taxpayer's books and records – if we conclude there may be noncompliance,

FSLG is also greatly increasing the number of traditional examinations. In FY 2002, we did practically no exams. In FY 2003, FSLG closed 411. This year we will close 1,250 exams, and in FY 2006 we plan to close more than 1,400. So you see what I mean by re-balancing.

How are we focusing the increase in contacts? The Commissioner gave us resources for two initiatives. First, part of our new resources this year went to create a large governmental employer examination program. This large case program focuses on entities that have payroll in excess of \$40 million. About 3% of state and local governmental entities fall into this category. These are fairly large governmental entities, and the issues that surface during an examination are often complex. We began 21 large case examinations in FY 2005, and plan to open 20 additional large case exams in FY 2006.

Second, I told you that equity demands that if we step up our work with state and locals governments, federal agency contacts must also increase. So, the second piece of our new resources went to this part of our program. We have created a federal agencies group. This group is dedicated solely to federal agency examinations and educational events.

In 2005, FSLG began the examination of 8 federal agencies or sub-agencies. In FY 2006 we plan to open 15 more federal examinations. So, we are not singling out the states for special treatment. To cite one example in this area, some federal contractors are not withholding properly, and agencies employing these contractors are not complying with the law that requires them to do backup withholding. FSLG and the Service have been at work in this area, and as a result, several federal agencies have just filed over 240,000 information returns,

covering \$125 billion in payments to federal contractors. It is a good start, but there is much yet to be done in this area.

With the two new focus areas of large case and federal agencies, we will have programs covering 38% of all governmental employers. But these employers account for 98% of all government wage earners and taxes paid.

While I am talking about our examinations, let me touch on what kinds of problems we are finding. Let me very briefly mention four, though Sunita will go into more detail on Tuesday. None will be a surprise to you.

First are worker classification issues -- Are workers employees or not? This is under examination in all segments -- federal, state and local.

Second are fringe benefit issues, such as moving expenses. This also is under exam in all segments.

Third is the improper classification of legal settlements we have identified at the federal level.

And finally, the one I need your help on -- errors involving Section 218 agreements. There are numerous issues here having to do with the inclusion or exclusion from FICA coverage.

I have spoken about large employers. While we have the large entities covered, we will continue a vigorous review of smaller entities, mostly via compliance checks and other techniques.

In this regard, let me give you an example of an enforcement technique we have used, and expect to continue to use increasingly into the future, to help us get at similar employers.

The issue we address in one pilot of this technique is the failure of some small municipalities to file and pay employment tax. We are conducting this pilot in three phases.

Phase 1 took place over the past two years. One of FSLG's field groups conducted extensive outreach activities to educate small municipalities about their filing obligations.

In Phase 2, FSLG group sent out so-called "soft notices" to entities that had not filed the appropriate employment tax returns. The soft notices said, in essence, we are aware you have not filed, and this is your opportunity to correct that behavior by filing the return. The results were favorable. Of the 2,000 municipalities we contacted, 1,600 filed returns. But 400 did not.

In Phase 3, we are going to conduct audits of these 400. This overall approach is what I mean by re-balancing. We will continue outreach and customer education, and we will always help governmental entities meet their obligations. But we will follow up if they do not.

So that is how we are re-balancing at the Service, and most importantly, how we are re-balancing FSLG.

Looking forward, the President is strongly committed to continuing to boost enforcement at the IRS. In the proposed 2006 budget, the Administration has called for a 4.3-percent increase in IRS funding – with a nearly 8-percent increase for enforcement.

Looking forward in the FSLG area, we intend to normalize our examination program. You can expect to see the level of examinations stay at or above the 1,400 range. We also intend to continue our close and constructive partnerships with representatives of the FSLG community. Our emphasis on enforcement continues to be coupled with a desire for dialogue.

In closing, let me thank each of you for your work and for your membership in the NCSSSA. As I have mentioned, we consider you our partners. You help your state agencies and political subdivisions follow the law and understand their social security tax obligations. We will try to help you as best we can – by continuing to improve our electronic and information services, updating our computers, and insisting on compliance.

Thank you for your invitation and for your attention.